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Index funds invest trillions but rarely challenge management

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18 MIN READ

(Reuters) - Index funds now control half the U.S. stock mutual fund market, giving the biggest funds enormous power to influence decisions and demand better returns at the companies in which they invest trillions of dollars.

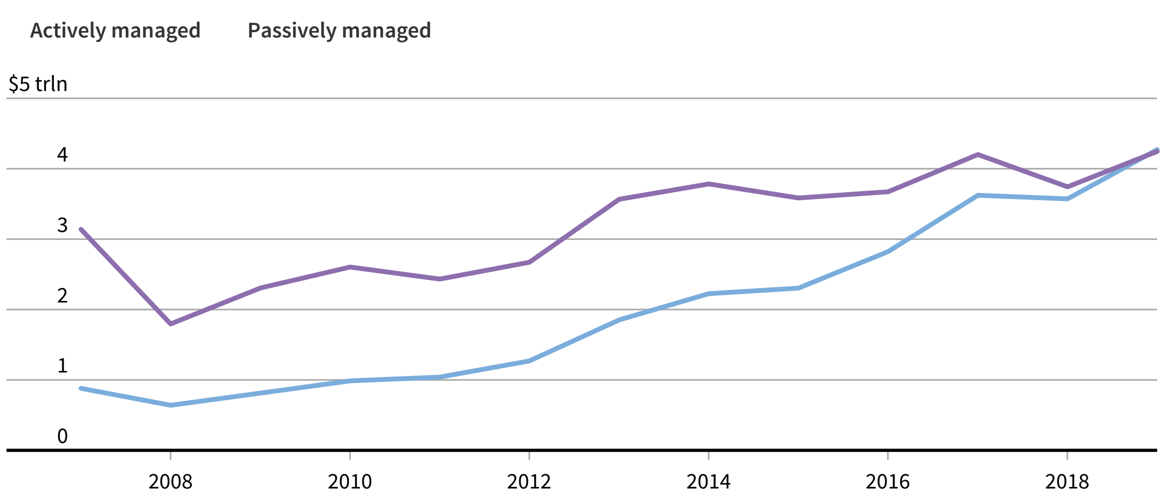
FILE PHOTO: Blackrock's Richard Prager rings the opening bell above the floor of the New York Stock Exchange (NYSE) in New York, U.S. May 31, 2019. REUTERS/Lucas Jackson/File Photo

But the leading U.S. index fund firms, BlackRock Inc, Vanguard Group and State Street Corp, rarely use that clout. Instead, they overwhelmingly support the decisions and pay packages of executives at the companies in their portfolios, including the worst performers, according to a Reuters analysis of their shareholder-voting records.

The three fund firms, for instance, supported doubling the pay of the chief executive at California utility PG&E Corp after its stock plummeted over potential liability from maintenance problems linked to California wildfires. The funds supported big pay packages for executives at beauty products company Coty Inc - including nearly $500,000 for their children's tuition - as the company struggled to digest its acquisition of Procter & Gamble's beauty business. And all three cast pivotal votes against the proposed reform of splitting the CEO and chairman roles at General Electric Co after a decade of poor performance.

The rise of U.S. index funds

At the end of August, passive U.S. stock funds managed $4.27 trillion — slightly more than the $4.25 trillion in actively managed U.S. stock funds.



Morningstar | Note data is through Aug. 31
Feilding Cage | REUTERS GRAPHICS

Such votes reflect a larger trend of deference to management, according to an analysis of proxy voting at 300 of the worst-performing companies in the Russell 3000 index, as measured by three-year returns through the end of 2018. The analysis was conducted for Reuters by shareholder-voting data firm Proxy Insight.

The study looked at the 300 worst performers who held proxy votes in 2018. It found that BlackRock voted with management 93% of the time, followed by Vanguard at 91% and State Street at 84% during the proxy year ended June 30, 2018. The analysis showed that the three index fund firms supported management at the worst-performing Russell 3000 firms only slightly less often than they did for all companies in the index, regardless of performance.

“If we think that informed and engaged shareholders play an important role in disciplining company management, the rise of index investing is a problem,” said Dorothy Lund, a law professor at USC’s Gould School of Law and an author of several published corporate-governance studies.

Actively managed funds also routinely support management in proxy ballots. But their voting records are not directly comparable to those of index funds because active managers routinely signal their displeasure with company management by simply dumping a stock or never buying it. Index funds, by contrast, are prevented from active trading by their own rules because they aim to match, rather than beat, the market. They are required to own all the companies in the index they track, such as the Russell 3000 or the S&P 500 - high-flyers and dogs alike.

That leaves proxy voting as the primary leverage for index funds firms to hold companies accountable for practices that undermine shareholders’ interests, such as exorbitant executive pay. But the index providers face powerful disincentives in confronting management at the companies in their portfolios, industry experts said.

With no mission to outperform market indices, the funds lack a financial incentive to ensure that portfolio companies are well-run, Lund said. Their business models also rely heavily on recruiting everyday investors away from actively managed mutual funds with the promise of lower fees. And large companies - like the ones in major stock indexes - are key to acquiring new customers for the big fund firms: BlackRock, Vanguard and rival firms count on corporations to offer their funds to employees in retirement plans, which often limit the options workers can select.

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Those vital business relationships mean index funds treat their portfolio companies more like clients, Lund said in an interview.

“The problem is going to be greater as these index funds get more money,” she said.

The index fund firms say they take seriously the watchdog role that institutional investors have historically played in the stock market. Proxy voting, they say, is only a small part of their regular engagement with companies, and they prefer to address problems privately.

“Continuing to have a dialogue without airing all of our dirty laundry” helps maintain long-term relationships, said Glenn Booraem, who oversees Vanguard’s proxy voting and its interaction with portfolio companies.

BlackRock said it talks or emails with executives and directors - sometimes for years - before voting against them. “A vote against management is a sign of a failed engagement,” Michelle Edkins, who oversees BlackRock’s proxy voting, said in an interview.

“It’s wrong to measure the effectiveness of BlackRock’s investment stewardship efforts solely by our proxy voting record,” BlackRock said in a statement. “That fails to recognize our process of engaging directly with companies to enhance the long-term value of our clients’ assets.”

BlackRock, State Street and Vanguard all declined requests to discuss their votes on specific proxy proposals at poor-performing firms, or to provide details of their private interventions at laggard companies. State Street declined to make executives available for comment.

“We use our voice and vote to influence companies on long-term governance and sustainability issues,” State Street spokeswoman Olivia Offner said in an email.

Proxy votes on proposals by the company or its shareholders, influence key issues of executive pay, director appointments and strategic plans, along with a company’s actions to address controversial issues such as climate change or gender pay equity.

BlackRock opposed executive pay just 3% of the time in 2018 at Russell 3000 companies and Vanguard opposed pay 5% of the time, according to Proxy Insight. State Street funds did not support pay 9% of the time in that group of companies, according to Proxy Insight. The figure includes a small number of abstentions by State Street.

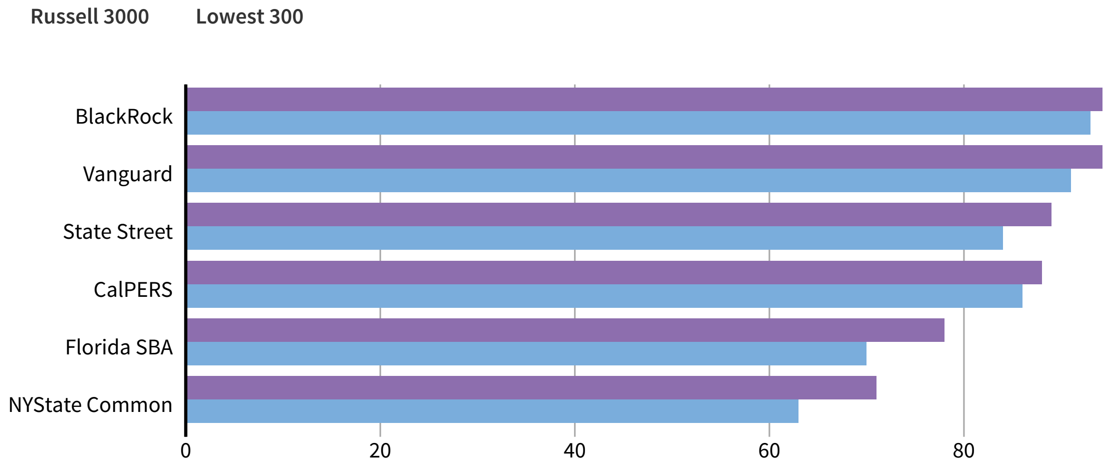
Compare that to America’s largest public retirement funds. The $378 billion California Public Employees’ Retirement System opposed executive pay 53% of the time in the first seven months of 2019 at U.S. companies, according to its latest report.

The $210 billion New York State Common Retirement Fund opposed executive pay packages 27% of the time last year at U.S. companies, a spokesman for the fund said. The $200 billion retirement system run by the Florida State Board of Administration voted against executive compensation 64% of the time among 2,226 U.S. companies during the twelve months ended June 30, Jacob Williams, the system’s corporate governance manager, told Reuters.

U.S. index funds support of management

In shareholder votes, the top three U.S. index fund firms — BlackRock, Vanguard and State Street — supported management at the worst-performing firms in the Russell 3000 only slightly less often than they did for all companies in the index. Some big pension funds voted more critically.

PERCENT OF SUPPORT



Proxy Insight | Note: Data for 12 months ending June 30, 2018.
Feilding Cage | REUTERS GRAPHICS

Some activist investors cite the low rate of negative votes by top investors as a reason for the persistence of unpopular corporate practices, such as rich executive compensation and poor disclosure of climate impacts. Median CEO pay rose 25% to $12.1 million in 2018 from $9.7 million in 2014 at the 500 largest publicly-traded U.S. companies by revenue, according to the latest disclosures analyzed by executive pay researcher Equilar.

Company leaders usually won't even discuss an issue unless about a third of investors cast opposing votes, said Tim Brennan, who until June oversaw proxy votes and resolutions as chief financial officer for the Unitarian Universalist Association.

"The votes definitely matter," he said.

CalPERS investment director Simiso Nzima said CEO pay design would improve if other big investors voted more critically.

"Talking to companies behind the scenes on this particular issue is a bit like trying to boil the ocean," Nzima said.

'EXCESSIVELY DEFERENTIAL'

Few foresaw an investing revolution when Jack Bogle of Vanguard introduced the first index fund, now called the Vanguard 500 fund, in 1976. Rather than trying to beat the market, Bogle simply sought to match it - while chopping fees to investors. Bogle, who died in January, often recalled how early index funds were disparaged as mediocre, even called “un-American.”

After the 2008 financial crisis whipsawed retirement account balances, many investors stopped trying to beat the market and embraced the lower fees of passive funds. At the end of August, passive U.S. stock funds managed $4.27 trillion - up from less than $1 trillion before the crisis, and slightly more than the $4.25 trillion in actively managed U.S. stock funds, according to research firm Morningstar Inc.

Challenging company management in proxy votes creates adversarial relationships that do not serve the business interests of the index funds, Lucian Bebchuk, a Harvard University corporate governance scholar, wrote in a May research paper. The index fund firms are “excessively deferential” to the managers of their portfolio companies, he wrote, because that approach better serves their corporate mission to grow their assets-under-management - and the fees that come with managing those assets. Bebchuk and several other academics say the index fund providers do not want to rankle senior management at publicly traded U.S. corporations because they also want to make money selling index funds to their employees through company retirement plans.

Effectively monitoring the thousands of firms in stock-market indexes would also require considerable staff and resources with little tangible payoff to an index fund’s bottom line. Because the funds all own the same stocks – under formulas calibrated to track a broad index – they can’t compete with one another on market performance. Instead, they compete with aggressive discounting of fees.

Those low costs are also the biggest selling point of all index funds over their actively managed competitors, which must charge more to pay for teams of managers who constantly research companies and cull low performers from their portfolios.Index funds’ business model and cost pressures don’t allow for much company research, said Ron Gilson, a professor at the law schools of Columbia University and Stanford University who follows the industry.

“There’s not much room for them to be investing in stewardship, particularly when real stewardship is expensive and you’re charging some customers close to a zero management fee,” Gilson said in an interview.

BlackRock, for instance, has 45 people on its team that handles proxy votes, according to a company report in August. The votes cover about 16,000 corporate meetings per year. Last year, the Los Angeles County Employees Retirement Association (LACERA) moved about $10 billion in equity index assets into accounts that would allow the retirement plan to take over proxy voting – and take it away from external portfolio managers including BlackRock, according to publicly available meeting minutes.

With expanded voting power, LACERA’s support for management proposals dropped to 80% in 2018 from 93% the previous year, when BlackRock had more sway, according to LACERA board presentations. Support for shareholder proposals rose to 74% in 2018, up from 56% support in 2017. LACERA declined to comment.

BACKING EXECUTIVE PAY

During the 2018 proxy season, top index fund providers supported corporate leaders through some trying times for shareholders of the companies in the bottom 10% of the Russell 3000 index.

The three funds' backing of a big raise for PG&E chief executive Geisha Williams - to $8.6 million in 2018 from $4.2 million the year before - came after the company suspended its dividend. The executive pay package received overwhelming support from other investors, even though a stable dividend is a key reason for owning utility stocks. PG&E stock lost a quarter of its value in 2017. The utility sought Chapter 11 bankruptcy protection earlier this year after severe wildfires in 2017 and 2018 resulted in more than $30 billion in liabilities amid investigations into whether the utility's equipment had caused the blazes.

When the index fund companies helped defeat the proposal to split the chairman and CEO roles at GE in 2018, their huge stakes in the company allowed them collectively to cast 1.3 billion votes against the measure out of a total of 2.8 billion votes in opposition. Investors supporting the measure cast nearly 2 billion votes in favor, hoping to curb the power of GE's CEO in the boardroom.

In November 2017, the three index fund firms unanimously backed the pay packages at beauty products company Coty Inc, one of the worst performers in the Russell 3000 index after losing 72% of its value in the three years ended in 2018. The nearly $500,000 in tuition payments for executives' children – an unusual perk – came as part of pay packages that ranged from $3 million to $12 million. The Florida State Board of Administration was one of the few dissenters to vote against Coty's pay arrangements.

Slideshow (7 Images)

The large index funds also backed the re-election of Coty Chairman Lambertus Becht, who received a special $3.6 million payout for his work on the company's $12.5 billion acquisition of Procter & Gamble's beauty business in 2016. Top proxy adviser Institutional Shareholder Services said Becht's total compensation of $4.6 million "significantly exceeds market norms for non-employee director pay." Other major investors voted in favor of Becht's re-election, but some dumped Coty's stock as it struggled to digest the acquisition.

Spokespeople for PG&E, General Electric and Coty declined to comment for this story.

It’s rare in proxy voting for a majority of investors in a company to oppose executive pay packages. Even in such cases, BlackRock usually supports management. In 2018, among the 57 companies in the Russell 3000 that failed to win a majority of investor support for their pay plans, BlackRock sided with management about 60% of the time, according to consulting firm Semler Brossy and company voting records.

BlackRock supported rich pay packages for directors at Clovis Oncology, who each earned about $500,000 a year despite the firm’s modest market capitalization of $1.4 billion. That’s twice the typical pay of directors at the 500 largest U.S. companies by revenue, according to Equilar. Vanguard and State Street sided against BlackRock. In all, 58% of votes cast were against a proposal to ratify director pay. Clovis, which declined to comment, responded by cutting director pay by one-quarter after taking into account the low support and investor feedback, the company said in its 2019 proxy.

Switch Inc CEO Rob Roy received nearly $100 million in compensation in 2017 when he took the Las Vegas-based data center operator public. The following year, BlackRock backed the election of three directors on Switch’s compensation committee who had awarded Roy his big pay package. State Street backed two of them. Vanguard voted against all three on the compensation committee.

“The awards are unusual, and the complete lack of performance-vesting criteria heightens concern,” proxy advisory firm ISS wrote in a May 2018 research report. Each of the three Switch directors received 97% of votes cast.

Switch shares lost about two-thirds of their value in the 15 months after its October 2017 initial public offering. Switch and CEO Roy declined to comment.

ALL ABOARD FOR AN $84 MILLION PAYOUT

In one case, BlackRock noted concerns about a big payout to an executive but voted for it anyway.

In February 2017, legendary railroad executive Hunter Harrison demanded $84 million in upfront money to join CSX Corp as CEO. BlackRock balked at the size of the payment and cited investor concerns about Harrison’s health, according to a June 2017 BlackRock report on proxy voting. Before investors voted on his pay package, a Wall Street Journal story detailed how an undisclosed medical condition forced Harrison to work from home, breathing with the help of an oxygen machine.

BlackRock, which owned a 6% stake in the rail firm, put aside its concerns and supported the pay package, which received 93% support from all investors. Vanguard, with a 7% stake, and State Street, with around 4%, also voted in favor. Several months later, in December 2017, Harrison died.

CSX adopted a rule requiring its next CEO to submit to a physical examination. The resolution that prompted that change at CSX was filed by Virginia attorney John Fishwick Jr., and it was adopted by the company before any vote. He said he was surprised none of the big fund managers stepped up with their own proposal. CSX declined to comment on Harrison's pay.

"These funds talk a big game, using a lot of flowery language," Fishwick told Reuters in a phone interview. "I have not seen that they've done much."

(GRAPHIC: Index funds now control half the mutual-fund market - here)

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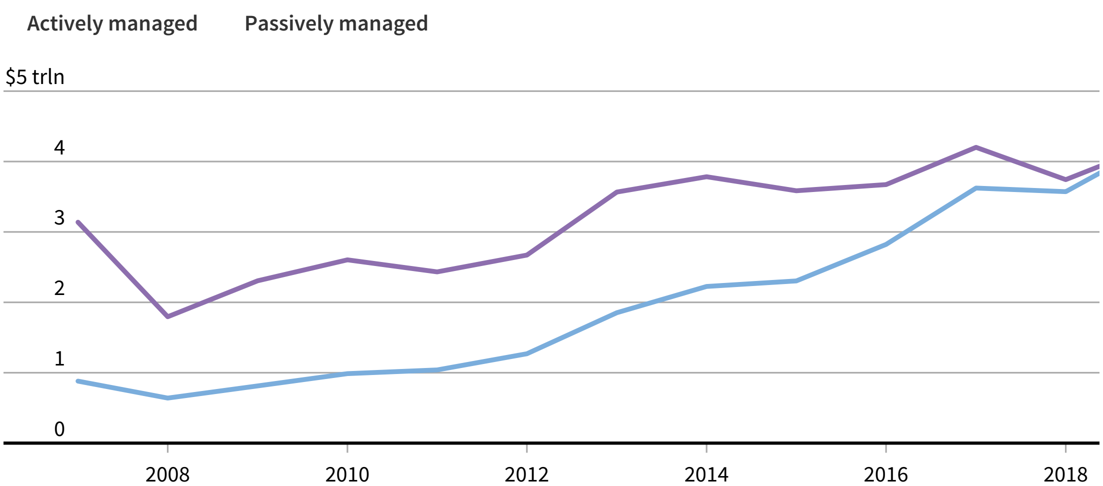

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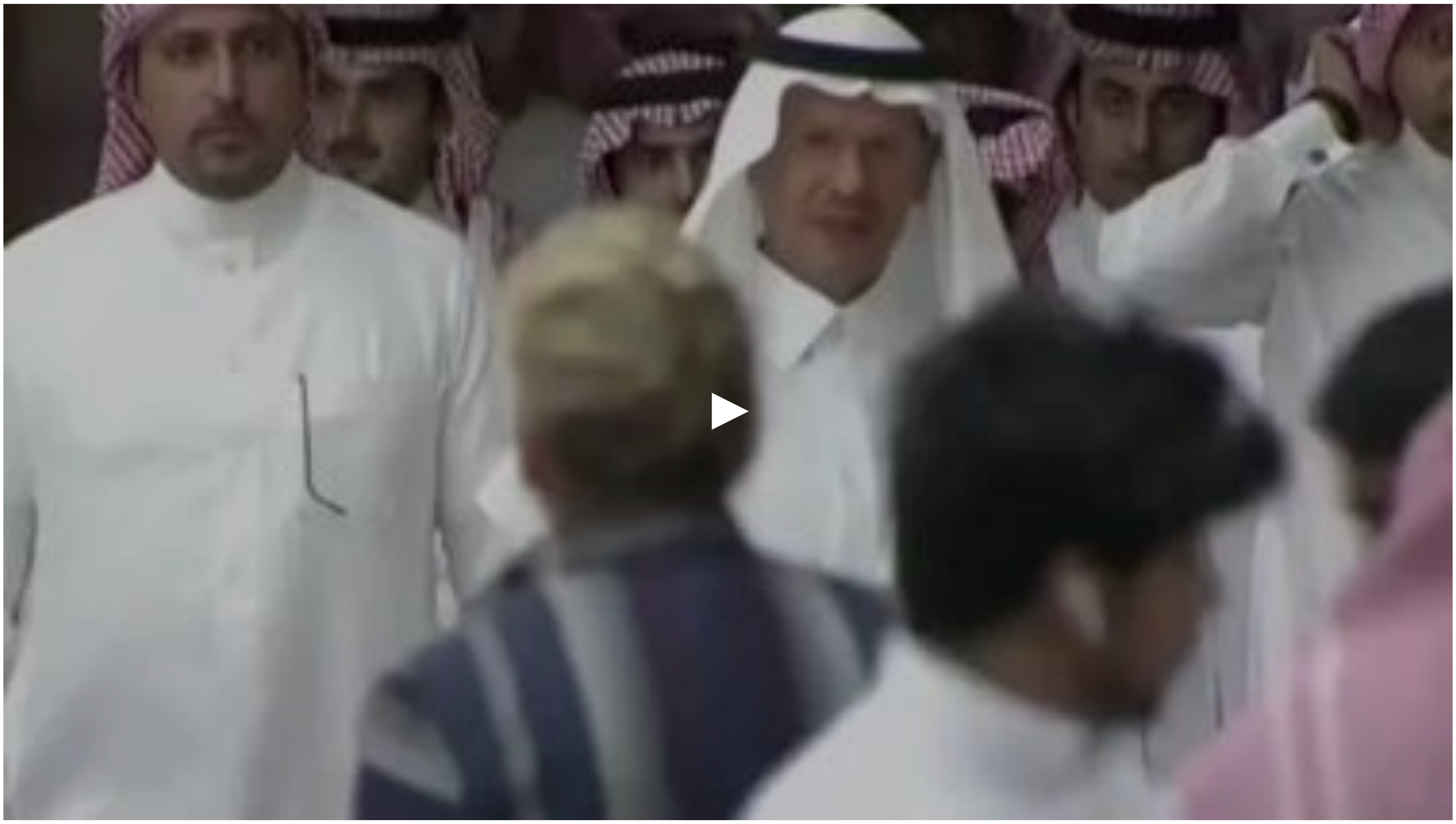

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